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STATE FOR EUR/NB  
TREASURY FOR ERIC MEYER AND LARRY NORTON

SIPDIS

SENSITIVE

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SUBJECT: ICELAND SCENESTTER FOR TREASURY DAS ERIC MEYER'S VISIT

11. (SBU) Summary: Since your previous visit three months ago, you'll find many changes in Iceland's economic and political landscape. Businesses are hurting and unemployment has risen to an unprecedented ten percent. Currency restrictions imposed in December were extended another six months until September 1. News is not good on aluminum and fish, the two export-oriented pillars that are helping to prop up the ISK. Following the escalating protests in January, the government fell and a leftist coalition was established. Consequently, you'll be meeting a few new faces at the Ministries of Finance and Business Affairs and the Central Bank. As the IMF team found during their recent visit, the political turmoil has delayed dealing with crucial issues like resolving IceSave account guarantees. Pressure is rising on the Central Bank to lower interest rates, while the public's desire for EU membership and Euro adoption has deflated somewhat, with only the business community strongly advocating this move. The parties in the interim coalition government are acting cautiously, knowing their actions today directly affect whether they will be elected in general elections slated for April 25. The vital question of how the Icelandic economy will adapt to the new global economic realities remains unclear. End Summary.

12. (SBU) The economic situation in Iceland has visibly deteriorated since December. Unemployment is currently at 10.3 percent, a dramatic rise from under two percent just five months ago. When you were last in Iceland, there were anecdotal claims that up to 70 percent of businesses were technically insolvent because the depreciating ISK had ballooned their foreign currency loan payments.

That has proven to be the case. In addition to vacant construction sites with half-finished projects, a walk down the main shopping street in Reykjavik reveals newly vacant storefronts from failed businesses or desperate posters for final sales. Other signs of the hard times include Baugur, one of the biggest holding companies in Iceland, declaring bankruptcy and the Financial Supervisory Authority's takeover of investment bank Straumur-Burdaras on March

19. The temporary capital controls that expired March 1 were extended an additional six months. The ISK is being helped by a small trade surplus, although the two main pillars for exports, aluminum and fish, have suffered in the global downturn. Worldwide aluminum demand has dropped, and the resulting price decreases have slowed production at the country's smelters. The reduced demand for fish has fisherman storing their catch; we hear reports that the freezer capacity is nearly maxed out.

13. (SBU) The public discontent over the economic situation and the government's apparent lack of action led to a series of escalating public protests. As a result, the centrist government fell in January, and a leftist interim coalition was put in place. The most relevant Cabinet changes to your visit are the new Minister (and Permanent Secretary) at the Ministry of Finance, a new Minister of Business Affairs, and a new Prime Minister. Minister of Business Affairs Gylfi Magnusson, whom you will meet, is a non-political academic educated at Yale. Upon installation of the new government, the Central Bank leadership structure was changed which resulted in

the hire of a Norwegian interim Bank Director. The Board at the Financial Supervisory Authority was also changed, with another academic appointed as Chair.

¶4. (SBU) As the IMF team found during their two-week visit that ended last week, the political turmoil has delayed dealing with crucial issues like resolving the dispute with the UK and other EU countries over deposit guarantees for the IceSave accounts. The interim coalition is acting cautiously, knowing their actions today and the public perception of those actions will directly affect the outcome of the April 25 general elections. Inconclusive public opinion polls have given the parties little ground to feel confident, and they are watching every move carefully. As an example, one of the first acts of the new Minister of Health was to reverse the unpopular cost-cutting decision of his predecessor to close a small hospital, despite the fact that his Ministry is under the gun to make nearly ISK 7 billion (\$60 million) in budget cuts. There is pressure on the Central Bank to lower the prime index rate. However, public calls to join the EU and adopt the Euro are not as intense as in October. Only the business sector continues to advocate this position; the latest poll indicated 54.5 percent of the general public were against joining the EU.

¶5. (SBU) The change in government has also loosened tongues and you'll find many interlocutors are offering details of the situation leading up to the banks collapse. The government was criticized for not investigating criminal activities within the banks and the international corporations, and as a response French-Norwegian anti-corruption crusader Eva Joly has been hired as a special government consultant for the investigation of economic crimes. Mysterious leaks to the media of the banks' loan books are revealing that the banks' owners were manipulating their stock prices and that the quality of loans (previously touted as sound) deteriorated

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before the collapse.

¶6. (SBU) Comment: Installing new experts in key positions such as the Central Bank, the Financial Supervisory Authority and some ministries, is positive and will provide needed expertise. However, given that the interim government is acutely aware of the impending April 25 general elections, it is unclear how much progress will be made before a new government is installed. The vital question of how the Icelandic economy will adapt to the new global economic realities remains unclear. End Comment.

VAN VOORST